# ABUSIVE TRUSTS SCHEMES

## Abusive Domestic Trust Schemes

Domestic trusts are trusts created in the U.S. Here are some common abusive domestic trust schemes:

- **Business trust**

  This involves the transfer of an ongoing business to a trust. Also called an unincorporated business organization, a pure trust or a constitutional trust, it gives the appearance that the taxpayer has given up control of his or her business. In reality, through trustees or other entities controlled by the taxpayer, he or she still runs the day-to-day activities and controls the business's income stream. Such arrangements provide no tax relief. The courts have held that the business income is taxable to the taxpayer under a variety of legal concepts, including lack of economic substance (sham theory), assignment of income, or that the arrangement is a grantor trust. In some circumstances, the trust could be taxed as a corporation.

- **Equipment or service trust**

  This trust is formed to hold equipment that is rented or leased to the business trust, often at inflated rates. The business trust reduces its income by claiming deductions for payments to the equipment trust. This type of arrangement has the same pitfalls as the business trust, and it will result in no tax reduction.

- **Family residence trust**

  Taxpayers transfer family residences and furnishings to a trust, which sometimes rents the residence back to the taxpayer. The trust deducts depreciation and the expenses of maintaining and operating the residence including gardening, pool service and utilities. The courts have consistently collapsed these types of trusts, taxing income to the taxpayer and disallowing personal expenses.

- **Charitable trust**

Taxpayers transfer assets or income to a trust claiming to be a charitable organization. The trust or organization pays for personal, education or recreation expenses on behalf of the taxpayer or family members. The trust then claims the payments as charitable deductions on its tax returns. These alleged charitable organizations often are not qualified and have no IRS exemption letter; hence, contributions are not deductible. Charitable deductions are not allowed when the donor receives personal benefit from the alleged gift.

- **Asset protection trust**

  These trusts are promoted as a means of avoiding liability for judgments against an individual or business. However, beware of any asset protection trust marketed as part of a package to reduce federal income or employment taxes. The courts can ignore such trusts and order the taxpayer's property sold to satisfy the outstanding liabilities.

## Abusive Foreign Trust Schemes

Abusive foreign trusts are often formed in foreign countries that impose little or no tax on trusts and also provide financial secrecy. These are usually "tax haven" countries, supposedly outside the jurisdiction of the U.S. Typically, abusive foreign trust arrangements enable taxable funds to flow through several trusts or entities until the funds ultimately are distributed or made available to the original owner, purportedly tax-free. In actuality, the income from these arrangements is fully taxable.

Foreign packages often begin with an Asset Management Company, a business trust, and then distribution of income to several trust layers. These schemes also involve offshore bank accounts and International Business Corporations (IBC's). A typical abusive foreign trust scheme has the following steps:

- **Asset Management Company**

  In many promotions, taxpayers are advised to create asset management companies (AMC's). The AMC, which lists the taxpayer as the director, is formed as a domestic trust. An individual on the promoter's staff is usually the trustee of the AMC, but the taxpayer quickly replaces this individual. The purpose of the AMC is to give the appearance that the taxpayer is not managing his or her business and to start the layering process.

- **Business Trust**

  The next step is to form the business trust, again very similar to the domestic scheme.

- **Foreign Trust One**

  Next, a foreign trust is formed in a tax haven country and the income from the business trust is distributed to this trust. We will refer to this foreign trust as "foreign trust one". In many cases, the AMC will be the trustee of foreign trust one. Because the source of income is U.S. based and there is a U.S. trustee, this foreign trust has filing requirements as discussed earlier in this section.

- **Foreign Trust Two**

  The next step is to form a second foreign trust or "foreign trust two". All income of foreign trust one is distributed to foreign trust two. Either foreign trust one or a foreign member of the promoter's staff becomes the trustee of foreign trust two. If the trustee is foreign trust one, the taxpayer still controls foreign trust two by the fact that he/she is in control of foreign trust one's trustee, by the directorship of the AMC. If a foreigner is the trustee of foreign trust two, the taxpayer is empowered by the promoter to overrule any decisions by this trustee. In either case, the taxpayer is in control of foreign trust two.

Promoters will claim that since the trustee and the sources of income are now foreign, there are no U.S. filing requirements. Promoters also advise taxpayers that since the trusts are formed in tax haven countries it is impossible for the IRS to determine who is in control of the trusts. In actuality, the taxpayer has never relinquished control of their business, but has set up, with the assistance of a promoter, an elaborate scheme to subvert and evade U.S. tax laws.

- **Asset Protection Trust**

  Either as part of the second foreign trust or as a separate trust, an asset protection trust is formed. The taxpayer supposedly transfers all of his assets to it including his home and other assets actually located within the United States. According to the promoter, this will make the taxpayer judgment-proof. In actuality, the courts look at the economic substance of the transaction and, if the taxpayer continues to reside in his home and control his assets, those assets may be seized and sold in satisfaction of his liabilities. This definition of an asset protection trust is not meant to imply that all are formed as part of an abusive tax scheme. However, beware of any asset protection trust marketed as part of a package to reduce federal income or employment taxes. The courts can ignore such trusts and order the taxpayer's property sold to satisfy the outstanding liabilities.

## V. Accessing the Offshore Funds

How do taxpayers involved in these schemes enjoy the fruits of their abusive scheme since their funds are offshore? There are several methods to repatriate the taxpayer's funds to the U.S. All of these methods, at some point, involve the opening of foreign bank accounts. Two examples are described below:

- A bank account is opened in the tax haven country and a debit or credit card is issued from the account. These cards are used by the taxpayer in the U.S. to withdraw cash and to pay for everyday expenses. Since the cards are issued by banks located in tax haven countries, it is very difficult for the IRS to trace these transactions back to the taxpayer.

- An International Business Corporation (IBC) is established. Funds are transferred from the foreign trusts to the IBC via foreign bank accounts. Fraudulent loans are set up from the IBC to taxpayers and funds are wired back to the taxpayers in the U.S. Because loans are generally not taxable, the repatriation of funds is not reported on a U.S. tax return. In addition, because the ownership of IBC's is documented with bearer shares and IBC's are located in tax haven countries, it is very difficult for the IRS to prove that fraudulent loans are actually the taxpayer's income.